AGENDA ITEM 6

TRANSPORT FOR LONDON
BOARD

SUBJECT: TUBE LINES PERIODIC REVIEW: RESPONSE TO ARBITER’S DRAFT FINDINGS

DATE: 3 FEBRUARY 2010

1 PURPOSE AND DECISION REQUIRED

1.1 The purpose of this paper is to:
   (a) provide a summary of the Arbiter’s findings issued on 17 December 2009 and the implications thereof;
   (b) describe LU’s response made to the Arbiter on 1 February 2010;
   (c) describe the position on Tube Lines (TLL) related issues, particularly as regards the line upgrades and claims; and
   (d) address the issue of the affordability of the works to be undertaken by TLL in the second Review Period (RP2) of the PPP Contract and the response to be made to the Arbiter’s questions on this issue.

1.2 The Board is asked to (i) note the contents of this report and the responses from LU and the Mayor to the Arbiter’s draft directions and (ii) to agree TfL’s response.

2 BACKGROUND

2.1 The PPP Contract with TLL commenced on 1 January 2003. It is a 30 year contract with a ‘Periodic Review’ every 7.5 years to re-set the costs going forward. The contract requires certain key deliverables (eg the Jubilee line upgrade) plus a general obligation to improve asset condition and deliver a target level of asset performance. LU pays TLL an ‘Infrastructure Service Charge’ (ISC) each 4-week period.

2.2 Under the contract TLL’s shareholders (now comprising Ferrovial and Bechtel) are entitled to earn an equity rate of return of 26%, and in addition TLL has Secondment Agreements with the shareholders under which a number (circa 150) of individuals are loaned to TLL. Under these agreements, Ferrovial and Bechtel receive payments from TLL which comprise both a hefty mark-up on the individual’s cost and a substantial additional payment based on the costs of overall work done by TLL, regardless of the number of actual secondees.

2.3 The company accounts for the holding companies of TLL reveal that up to 31 December 2008 (the first 6 years), the shareholders received £438m in secondment fees and staff costs. Over the course of RP1 and RP2, LU estimates that the shareholders will receive £1.1bn under the Secondment Agreements, of which ££800m should be regarded as excess profit once the fair market rate for the staff is deducted. Approximately £400m of this profit will be
paid in RP2 and this is additional to the sum of over £400m in dividends and interest on shareholder’s loans payable to the shareholders in RP2.

2.4 The Periodic Review process commenced formally in December 2008 when LU issued Restated Terms and its Affordability Constraints. The Restated Terms involved pragmatic scope reductions which it was anticipated would result in a decrease in cost from the current PPP Contract terms.

2.5 The TfL Board was advised on 5 November 2008 that, at that time, it was thought that, if the Arbiter’s determination of costs was in line with his Initial Ranges Guidance, then the Restated Terms would imply a funding shortfall, assumed to be financed by TLL as prescribed in the PPP Contract. The Board was advised that LU would continue to take steps to mitigate that gap, but in the event that these steps were unsuccessful, there was a risk that TfL would need to revisit its Business Plan. This was prior to the impact of the economic downturn and the measures adopted in the 2009 Business Plan.

2.6 Following the issue of Restated Terms, early in 2009 LU shared the build-up of its Affordability Constraints with the Arbiter and acknowledged that they would likely imply a need for further finance, based on the understanding of likely costs at that time.

2.7 On 30 June 2009, TLL submitted its pricing proposals to LU for RP2; TLL’s price was £6.8bn, well above LU’s view of base costs for RP2, which by June 2009 had materially reduced to £4.2bn based on the Initial Ranges Guidance provided by the Arbiter in 2008 with adjustments for pragmatic reductions in scope, reductions in the risk profile reflected in Restated Terms, and changes in economic conditions.

2.8 LU engaged with TLL over the summer of 2009 and came to various agreements over contract terms and scope which led to a marked reduction in TLL’s prices to £5.8bn, but they were still considered by LU to be unacceptably high, given its own assessment. LU’s view of RP2 costs reduced marginally to £4.0bn during this period (as the tightening of scope definition was offset by identified minor scope omissions); at this level of cost, no finance would be required.

2.9 On 23 September 2009, LU called upon the PPP Arbiter to set a fair price for the Restated Terms, as per the process defined in the PPP contract. As was reported to the TfL Board on 10 December 2009, the key remaining areas of disagreement between LU and TLL were:

(a) unit rates (and other pricing issues), overheads, central costs and Secondment Agreements;

(b) the programme for the Northern Line Upgrade (NLU) and the extent to which it should have been delivered in RP1 having been delayed by virtue of the late delivery of the Jubilee Line Upgrade (JLU);

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1 Restated Terms are part of the Periodic Review process whereby LU gets an opportunity to change the PPP Contract and TLL can revise its pricing for performing the obligations, whether LU changed them or not. Affordability Constraints represent LU’s best estimate at the time of the level of payment it expects to be able to afford to pay TLL.

2 All RP2 costs are expressed in 2008 prices.

3 The level of payments made to the shareholders by TLL under Secondment Agreements is one of the reasons why overheads and central costs are an issue – however, the original PPP Contract contains provisions that protect these cash flows in certain circumstances.
(c) the costs of the line upgrades; and

(d) access requirements for RP2 relating to upgrades.

2.10 The Arbiter published his draft direction on base costs on 17 December 2009 together with his views on scope, performance, and access; and whether the Restated Terms involve a material increase in risk. He also published 'Initial Thoughts' on affordability and financing. He requested representations from the parties and stakeholders by 1 February 2010.

2.11 The remainder of this paper describes his findings and considers the overall implications.

3 SUMMARY OF THE ARBITER’S DRAFT FINDINGS

3.1 The key points are:

(a) The Arbiter’s RP2 costs (£4.4bn) are close to LU’s view (£4.0bn) and much less than TLL’s most recent view (£5.8bn).

(b) The Arbiter has made no specific allowance to reflect the behaviour of LU as client under the contract.

(c) The Arbiter found that the Notional Infraco4 would have completed the Jubilee Line (JLU) and 72% of Northern Line (NLU) in RP1. The Arbiter disagrees with the procurement strategy adopted by TLL for the signalling upgrade contract placed with Thales in 2003.

(d) The Arbiter has allowed payments under the Secondment Agreements from TLL to the shareholders Ferrovial and Bechtel for RP2 (albeit based on his own assessment of costs rather than TLL’s).

(e) The Arbiter has largely accepted that the allowances for closures in RP2 set by LU in Restated Terms are sufficient.5

(f) The Arbiter has allowed £170m for differential inflation and an additional risk premium of £160m to reflect the high level of uncertainty in the forecast.

(g) The Arbiter found that Restated Terms did not involve a material change in risk and that Restated Terms reduced costs from the range he provided in 2008 by circa £900m as a result of reduced scope and leasing arrangements for the new Piccadilly Line Rolling Stock.

(h) The funding gap of £463m (outturn), as calculated by the Arbiter, between LU’s Affordability Constraints and the Arbiter’s findings would require TLL to raise additional finance6 in RP2 (to cover repayment of debt and interest) if the contract operated as intended.

4 Notional Infraco is defined in the PPP Contract and in broad terms is an Infraco with the same contractual obligations, third party contracts and financing arrangements as the actual Infraco, but which carries on its activities in an overall efficient and economic manner and in accordance with Good Industry Practice.

5 It should be noted this is Guidance only – TLL has referred this matter to dispute resolution as envisaged under the contract.

6 Finance means debt and/or equity.
(i) The Arbiter has invited LU and its stakeholders (TfL, the Mayor and DfT) to confirm whether the costs are affordable, or whether LU wishes to de-scope to avoid having to finance this amount. If it is to be financed, the Arbiter seeks representations on whether the finance would better be raised by TfL or TLL. A copy of the relevant questions is attached as Appendix 1.

4 AFFORDABILITY CONSTRAINTS

4.1 The PPP contracts were designed to deliver a scope of work over 30 years, comprising specific upgrades (with dates prescribed) combined with a general requirement to achieve improved asset condition. The Infraco would be required to raise finance in the early periods to cover the gap between the total costs and the amount that LU could afford to pay in ISC as notified to TLL and the Arbiter in its Affordability Constraints to deliver that scope (with repayment of debt and interest in later periods when the renewal programme would have been largely completed).

4.2 The contract contains adverse consequences for TLL if it fails to raise finance, unless LU has made changes in Restated Terms which make financing harder to raise than originally anticipated. All of this was purposefully designed to ensure that LU’s desired scope of work would be delivered, with the Periodic Review process every 7.5 years established to ensure a fair cost was paid for the work programme. LU’s ability to alter the structure and terms of the contract radically was constrained and other matters were fixed including the rate of return on the existing equity (at 26%).

4.3 According to the PPP contract, TLL is required to attempt to raise this finance if costs exceed LU’s Affordability Constraints. If TLL fails to raise the necessary finance, LU is given a series of options (“LUL Options”), including paying more or reducing scope so as to reduce cost. LU can decide not to exercise any of the options, in which case the contract will end through a process called ‘Special Mandatory Sale’ under which an LU nominee would acquire TLL through an asset transfer. As with Metronet, this would require TLL’s existing debt to be repaid (unless it was possible to agree direct arrangements with the lenders). The shareholders would receive nothing, unless the Arbiter found that LU had made changes to Restated Terms making finance harder to raise than anticipated, or it was established that a Notional Infraco was incapable of raising finance.

4.4 In terms of the contractual mechanisms, it is therefore highly significant whether a Notional Infraco would be incapable of procuring finance, for example, because of general market conditions, or whether there are specific characteristics of TLL which render it incapable of procuring finance, for example, because of non-delivery of the JLU or the level of inefficient future costs not covered by the Arbiter’s findings.

4.5 However, the Arbiter has indicated that, on his interpretation of the contract, he is not necessarily bound by LU’s stated Affordability Constraints, but can make it pay an ISC above this level. He has received legal opinions from both LU and TLL canvassing different contract interpretations and he states that taking his statutory duties into account, his position is that he should exercise his judgement to set the service charge appropriately and independently of the Affordability Constraints. He states that he has not yet reached a concluded view and LU strongly disputes his view in its Representations.
4.6 The potential effect of the Arbiter’s proposed contractual interpretation might be that TLL would be relieved of any obligation to raise further finance. This would also mean that TLL would never be faced with the need to provide a credible plan to potential new lenders demonstrating its ability to deliver its future obligations for the ISC set by the Arbiter, and would thus diminish the assurance that would otherwise have been provided by the application of private sector lending scrutiny to the deliverability and viability of the contract.

4.7 It would also mean that the LUL Options would never become available, so LU would be deprived of the ability it would potentially have had to descope later in the process, if TLL had been required to raise finance, but failed to do so.

4.8 The Arbiter has, as one of his statutory objectives, giving LU an opportunity to reduce scope if he considers the future cost of the PPP is more than it has said it can afford. He has therefore asked LU to confirm now whether it can afford the current scope and, if not, to state how it wishes to reduce scope.

4.9 However the Arbiter has made it clear to LU/TfL in the last few days that once he makes his final cost directions on 4 March 2010, there would be no further discretionary opportunity to reduce scope, save in limited (and unlikely) circumstances. This was unexpected, because LU does not consider it practicable to identify specific scope reductions until the costs are fixed when the Arbiter issues his final directions. Further, the Arbiter’s question on affordability was raised in a section of his document entitled ‘Initial Thoughts’, giving no hint that he considered this a once and for all opportunity.

4.10 LU has not responded directly to the Arbiter’s question in the Representations made to the Arbiter on 1 February 2010, but has maintained its position that the Affordability Constraints are binding on him, and that he should allow the consequential contractual mechanisms to operate as drafted. However, the Arbiter is expecting a substantive response to his question, without prejudice to LU’s position on the Affordability Constraints, regarding affordability by 5 February 2010.

4.11 Thus, the key issue is whether further reductions in scope should be proposed at this stage, recognising there may be no future opportunity to do so.

5 DE-SCOPING OPTIONS

5.1 There are very few further opportunities for reducing scope apart from in relation to the principal Line Upgrades that are at the core of the purpose of the PPP. Limited pragmatic scope reductions were made in Restated Terms and many of the practical propositions made in TLL’s proposals “Path to Affordability” submitted in June 2009 have been picked up in the engagement with TLL over the summer. Even if it were conceivable, the Upgrades represent a limited opportunity to reduce scope with the Arbiter ruling that 72% of the Northern line was to have been delivered (and paid for) in RP1, and with new Piccadilly trains to be bought with approval from Government for additional TfL borrowing that is currently ear-marked for that purpose alone.

7 Even if the Arbiter decided he had the power to set an ISC higher than the Affordability Constraints, he might not choose to do so, so the outcome is still uncertain.
8 There would be no such future option if TLL were able to raise the necessary finance.
9 LU does not accept that it is appropriate for the Arbiter to give this option to LU rather than follow the contractual process under which TLL would first be given an opportunity to raise finance.
5.2 It should be noted that there is some potential for changes to the contractual risk allocation which would reduce the affordability position somewhat - an example is for LU to bear greater risk around differential inflation, but this would require agreement from TLL because it is one of a range of so-called ‘entrenched’ provisions which cannot be unilaterally modified by LU (and hence is only likely to be agreed on terms favourable to TLL).

5.3 The anticipated profile of the funding gap is such that significant impacts arise in 2013/14 and subsequent years, so the effect is limited in the first three years of the TfL Business Plan. It should also be noted that the anticipated cost of purchasing the new Piccadilly Line trains causes additional pressures on the TfL Business Plan in 2013/14 because it exceeds the amount of additional borrowing that Government has allowed.

6 FUTURE FINANCE

6.1 The Arbiter has additionally asked for Representations on whether it would be better value for money for TfL to raise any future additional finance rather than for TLL to do so, noting his understanding that any new TLL borrowing would count against TfL’s borrowing limits, so would not result in any new money being available to TfL.

6.2 If TfL could accommodate the funding gap in its Business Plan, the cheaper option in absolute cost terms (ignoring wider value for money considerations) would be for ISC funding, rather than private finance. However, when wider considerations are made, this may not represent the most effective arrangement, and so TfL proposes to retain the requirement for TLL to raise the finance for the following reasons:

a) **Risk transfer.** Equity and up to 5% of debt stand to be lost if TLL fails to deliver, providing a strong incentive on management.

b) **Scrutiny.** TfL has no evidence that TLL has a credible plan for delivery of its current and RP2 obligations, as evidenced by the Jubilee Line Upgrade. If TLL is forced to raise ‘at-risk’ finance, the new lenders will require TLL to demonstrate that it can deliver those obligations. Such scrutiny should reduce the chances of a TLL contractual failure later. Whilst existing lending is in place, new lenders are expected to provide a far greater degree of scrutiny before putting their money at risk.

c) **Options kept open.** If TLL fails to raise the finance, LU would have the ‘LUL Options’ available, including reducing scope, amending the Affordability Constraints or as a default option, having the PPP agreement transfer to it under the SMS process. However, these options would no longer apply if the Arbiter were to relieve TLL of its financing obligation, as described in paragraph 4 above.

6.3 If TLL were to raise the finance, the finance requirement would be somewhat higher than the funding gap to cover the costs of repayment of debt and interest. The expected costs of finance are being explored and this also is a matter on which the parties are taking independent advice as envisaged by the PPP Contract from an adviser jointly appointed to advise the Arbiter. The preliminary advice will be available on 12 February 2010.
7 SUMMARY OF LU’S REPRESENTATIONS

7.1 The key points in LU’s Representations submitted on 1 February 2010 are as follows:

(a) LU agrees with the Arbiter’s approach to the treatment of the impact of LU’s behaviour as client.

(b) LU makes a number of Representations about the Arbiter’s draft findings on costs which if accepted would reduce the Arbiter’s costs by £724m to £3,672m.

(c) Around £470m of this is direct reductions in the cost of work and c.£200m is the excess fees payable to shareholders under the Secondment Agreements that LU believes should be disqualified (it is not possible to separate the excessive mark-up on secondees as this is in effect included in each asset area). The balance relates to differential inflation where LU considers the allowance of £160m for differential inflation risk to be excessive.

(d) LU supports the position adopted by the Arbiter in relation to the timing of the upgrades as described in paragraph 3(c) above.

(e) The Arbiter should disallow secondment fees on the basis of non-delivery of the JLU and the absence of any commitment from the shareholders to deliver the second period obligations at the level of costs envisaged by the Arbiter’s draft directions.

(f) The Arbiter’s findings in relation to the level of closures required to deliver the upgrades and other works are largely accepted.

(g) LU agrees that the Restated Terms did not give rise to a material change in risk.

(h) LU disagrees with the Arbiter’s treatment of LU’s Affordability Constraints.

(i) At the current draft determination on costs, LU considers that the funding gap would be £388m (as opposed to £463m), in outturn, taking into account various calculation issues and the higher costs of the Piccadilly line rolling stock.

(j) The Arbiter’s statement that TfL and TLL are in agreement that it would be better value for money for TfL to raise additional finance than TLL is not accepted for the reasons in 6.2; in particular, it removes the independent scrutiny by potential lenders as to whether TLL has a credible plan for delivering its future obligations.

8 RELATED ISSUES : LINE UPGRADES

8.1 TLL is now reporting completion of the Jubilee Line Upgrade (JLU) by 11 October 2010 in a contractual letter dated 24 December 2009. A programme of weekend closures up to Easter 2010 was shared at the TfL Board on 10 December 2009; a further 14 weekend closures are proposed by TLL through until completion in October 2010.
8.2 LU served a Corrective Action Notice (CAN) on TLL on 5 January 2010 requiring completion of the JLU by 11 October 2010, in line with their declared completion date. This is a contractual remedy which could ultimately lead to a mandatory sale if TLL fail to remedy the breach.

8.3 The impact of this on the completion date for the Northern Line Upgrade (NLU) remains unclear although TLL is currently set upon starting an intensive weekend closures programme from March 2010, with circa 65 weekends requested, plus early closing of the whole line north of Stockwell every Monday-Thursday for 16 months from July 2010 (that would mean last trains leaving central London by 22.30 hrs). LU has urged TLL to re-visit its plans to develop a much less disruptive approach.

8.4 In 2009, TLL submitted a Claim for £327m from LU for delay and disruption arising from LU’s conduct with respect to JNUP – this claim was rejected “in its entirety” by an independent adjudicator on 22 January 2010, with TLL found to bear full responsibility for the costs and delay. A summary is attached at Appendix 2.

9 AFFORDABILITY RESPONSE : DISCUSSION OF OPTIONS

9.1 As described in 3.1(i), the Arbiter has invited LU to indicate whether it can afford to meet an ISC payment based on his draft £4.4bn findings on costs, or whether it will amend the proposed obligations for RP2, that is whether to de-scope.

9.2 As indicated in para 5.1, LU has already, in the Restated Terms process, captured every conceivable change to scope without sacrificing the core objectives of the contracts, to deliver the major line upgrades according to the schedule prescribed. Further changes to scope cannot easily be identified. Consequently LU does not propose to make any further changes to the scope of works required for RP2.

9.3 LU believes that its further Representations to the PPP Arbiter make a clear case for a reduction in his cost assessment of over £700m, thus achieving an affordable outcome. However there is no guarantee that the Arbiter will accept these, or that he will not make other changes that off-set them.

9.4 Should the Arbiter’s determination of costs remain in the region of £4.4bn, this will leave a shortfall given LU’s available funds.

9.5 There are three remedies to this outcome:

(a) The Government is responsible for the construct of the PPP contract and purposefully designed it to deliver a scope of work with a Review point to re-assess the fair costs to achieve that scope. LU has fulfilled its role by holding down scope as far as possible, and successfully reducing TLL’s excessive cost claim by over £2bn (compared with its June submission). Government should therefore now provide funding to address the remaining gap.

(b) If Government is unwilling or unable to provide direct funding then the Arbiter should allow the Contract to operate as intended (as described in 4.2) with TLL now asked to raise the finance required, and the Government should allow TfL’s borrowing requirement to increase accordingly.
(c) If neither of these routes is available to LU, despite it being entirely contrary to the intention of the PPP contract for that to be the case, then there is one further route by which the affordability issue can be resolved without LU having to cut into its core work programme. As argued elsewhere in the paper, TLL’s shareholders – Bechtel and Ferrovial – earn excessive and unjustified fees under their Secondment Agreements with TLL that are over and above their handsome (26%) return on equity. As things stand, the expected payments by TLL under the Secondment Agreements, over and above any directly incurred costs associated with actual secondees, are estimated to be around £400m over RP2. The Arbiter should disqualify these payments, but in any case they should now be foregone by the shareholders.

9.6 The removal of these excessive fees would alone be sufficient to remove virtually all of the potential gap between the costs determined by the Arbiter and what LU can afford.

9.7 If this is not done, then it could otherwise mean that core LU upgrade programmes would have to be sacrificed simply in order that the TLL shareholders, Ferrovial and Bechtel, continue to receive unjustified and inflated payments. As an outcome for London this would be devastating.

9.8 It is proposed that the Board makes Representations for the removal of these fees. The Mayor has written to the Secretary of State and urged him to demand their removal.

10 RECOMMENDATION

10.1 The Board is asked to NOTE the contents of this report and ENDORSE the proposed response from TfL to the Arbiter, attached as Appendix 3. Specifically the Board is asked to NOTE that:

(a) No further de-scoping can be contemplated given all that is left is the major and critical line upgrades;

(b) LU’s Restated Terms can be affordable within current TfL funding provided that:

• the Arbiter accepts LU’s Representations and reduces his cost determination to £4.0bn or lower (including on the basis that the Secondment Fees paid out by TLL to its shareholders are unjustified and excessive); or,

• the shareholders themselves admit that they are unjustified and terminate this element of their Secondment Agreements; or,

• Government agrees to fund the difference, or permits additional public borrowing to do so; or,

• TLL raises the additional finance as foreseen in the original PPP contract.

10.2 The Board is therefore asked to NOTE that LU will respond to the Arbiter indicating that, with these options, the costs for RP2 will be affordable, and no further de-scoping will be proposed.
10.3 The Board is asked to NOTE the proposed response from the Mayor to the Arbiter, attached as Appendix 4.

11 CONTACTS

11.1 Contact: Richard Parry, Interim Managing Director, London Underground
Number: 020 7027 8499
Email: Richard.Parry@tube.tfl.gov.uk
Affordability position of London Underground

14.9 The stated intention of the request for guidance from London Underground on 14 April 2009 (the Initial Ranges guidance) was to help it to set its Affordability Constraints at Periodic Review. Following correspondence between himself, TfL and London Underground in Spring 2009, the Arbiter’s understanding is that:

- London Underground’s assessment of affordability in RP2 was based on the mid-point of the Initial Ranges numbers, adjusted for changes in Restated Terms;
- London Underground had accepted that this implied a need for further finance (potentially including equity) and, in the absence of agreement to the contrary, the PPP Agreement contained provisions in respect of Infraco raising this; and
- that TfL has discretion over its use of funds and therefore the capacity for additional finance raised by Tube Lines (or provided directly or indirectly by London Underground) to be accommodated within the TfL business plan (which incorporates the current funding settlement that TfL has with DfT).

14.10 As indicated in section 3, the draft directions on costs are within the range set out in the Initial Ranges guidance.

14.11 In light of the previous assurances that London Underground has provided, and on the basis that the cost and performance revenues are confirmed to be as in the draft directions, the Arbiter invites London Underground and its Stakeholders to confirm that the level of costs and performance revenue payments implied by the draft directions remains affordable. If this assurance cannot be given, the Arbiter invites London Underground, pursuant to the objective in section 231(2) of the GLA Act, to review and amend the proposed obligations for RP2 in its Restated Terms, as amended by the initial paragraph 6.5 guidance.

Financing issues

15.1 This chapter:

- sets out options for financing in RP2;
- sets out the Parties’ respective positions on Tube Lines’ contention of financing impossibility; and
- sets out the Arbiter’s initial thoughts on the matter.

Financing options in RP2

15.2 If London Underground does not consider that it needs to descope its requirements for affordability reasons, the next issue to consider is whether
TfL or Tube Lines should raise finance. As explained in chapter 14, the impact on the TfL financial settlement with DfT would be identical.

15.3 Both Parties have asserted that it would be better value for money for TfL to raise additional finance than for Tube Lines to do so. The Arbiter would welcome further representations on whether this remains the position of the Parties.
APPENDIX 2: SUMMARY OF ADJUDICATOR’S DECISION

The Adjudicator, Mr Alex Charlton QC, issued his decision in the Dispute between London Underground Limited (“LUL”) and Tube Lines Limited (“TLL”) as required by clause 4.7 of the Dispute Resolution Agreement (“DRA”) on 22 January 2010.

Mr Charlton’s decision is set out at paragraphs 681-682 of his reasons in the following terms: “TLL’s claim for £326,969,018 under TLL’s Notice of Adjudication dated 24 November 2009 is dismissed in its entirety. Insofar as any claim made in TLL’s June Submissions, the subject to LUL’s Notice of Adjudication dated 13 November 2009, is not subsumed by TLL’s Notice of Adjudication and TLL’s Submissions in support, I also dismiss it.

Accordingly, LUL is entitled to the declarations that it seeks as follows: That LUL has not breached the PPP Contract as alleged by TLL and is not liable for the amounts claimed (or any amount) in respect of the alleged breaches.”

The Adjudicator decided that TLL is to pay LUL’s costs and fees (paragraph 683).

The Adjudicator considered that in light of his finding on liability issues it was not necessary for him to deal with TLL’s Submissions on impact or delay and disruption (paragraph 680).

Variations: The gist of TLL’s claims was that LUL had somehow imposed variations upon it for which it deserved to be compensated. However, the Adjudicator rejected the contractual basis of TLL’s claim. Schedule 5.8 of the PPP Contract allows the parties to vary the PPP Contract by agreement.

TLL made submissions to the Adjudicator that this was the primary route by which the changes instructed by LUL were put into effect under the Contract. However, the Adjudicator concluded: “There is no evidence of any kind that suggests that either party complied with or attempted to comply with or intended to comply with the process that Schedule 5.8 prescribed. Accordingly, no change was made to the PPP Contract pursuant to Schedule 5.8 at any stage” (paragraph 43).

TLL further argued that LUL had varied the work under the contract pursuant to LUL’s narrow right to unilaterally vary the contract. The Adjudicator also dismissed this allegation on the basis that “There is no evidence to suggest that LUL was aware that TLL consider that which was going on amounted to a variation” (paragraph 62).

The Adjudicator described an argument made by TLL that it was entitled to additional costs in relation to the Jubilee Line Upgrade of up to £20million per 28 day payment period under the PPP Contract (rather than £20million in total) as “labyrinthine, artificial and unconvincing” (paragraph 60).

The Adjudicator concluded in relation to variations: “That TLL should have considered, at the relevant time, that the PPP Contract was being varied by LUL..., and yet make no attempt to invoke the contractual machinery, is not credible” (paragraph 72).

Deployment of the Seltrac System: Seltrac is the software system that TLL, through its subcontractor, Thales, is seeking to deploy on the Jubilee Line. The Adjudicator’s decision raises serious doubts about TLL’s management of this process. For example, the Adjudicator:

- Indicated, in respect of Seltrac that he would have expected TLL to adduce evidence of how the requirements engineering process was to work “at least in order to understand how LUL’s requirements were to be ascertained and fed into the design process” (paragraph 177);
• concluded that there was “no evidence that TLL or Thales adopted a structured approach to the development of Seltrac whereby there was clear communication of the dates by which each section of development has to be completed and a proper explanation of what was required by LUL by what dated. This is true of the SPWG [Signalling Principles Working Group]” (paragraph 289);

• stated that, “I am not persuaded that Seltrac did have the inherent functionality that met the requirements of the Category 1 Standards...irrespective of what LUL might have thought, I would have expected there to be some evidence that demonstrated TLL’s and Thales contrary views and some evidence of those views being explained to LUL. There is no such evidence. On the contrary, TLL, Thales and LUL appear to have proceeded at all times on the basis that something more that standard SelTrac was required. TLL’s case that it now advances is one that appears to have been fashioned with the benefit of hindsight” (paragraph 363).

**Standards and Standards Code:** The Adjudicator rejected TLL’s complaints in respect of LUL’s compliance with the Standards and the Standards Code, as well as the conduct of Phase 3 Review of the Category 1 Standards. In particular, the Adjudicator:

• considered that TLL had failed to notify LUL that it considered additional costs may be incurred as a result of the Phase 3 review, and that it was not able to do so now (paragraph 150);

• rejected TLL’s assertion that LUL was obliged to have reviewed and rationalised its Category 1 Standards on or before 31 December 2002 (paragraph 187);

• considered that “Not only was there no complaint from TLL around the time of the PPP Contract that the review [of the Category 1 Standards] was not complete, the evidence points inexorably to the conclusion...that TLL fully understood that the Category 1 Standards (and Category 2) were to be reviewed, that it should be involved in that review in accordance with the Standards code and that changes, re-grades or withdrawals of Category 1 Standards might or might not occur” (paragraph 196);

• concluded that TLL’s assertion that almost all discussion centred on new or increased requirements rather than the drafting of the Standards “strikes a false note” (paragraph 203);

• accepted that TLL contributed to the delay of the Phase 3 Review by its own conduct (paragraph 208-210) observing that TLL “did not participate in the process effectively or at all” (paragraph 236);

• dismissed TLL’s claim that the Phase 3 Standard’s were (i) overly prescriptive; or, (ii) a cut and paste of the old standards for want of evidence (paragraph 213-214);

• observed, in respect of events occurring following the introduction of the new Category 1 Standards on 30 May 2006 that “At that point, the „old” Category 1 Standards became Category 2 Standards and, as such, amendable to change as TLL saw fit. Obviously, what happened on and after 30 May 2006 cannot effect what went before (although, as I have held, there is no claim). However, it does serve to illustrate that TLL has only presented a partial picture of material events…What has occurred is no more that that which the parties bargained for” (paragraph 266).

**Signalling Principles:** The Adjudicator rejected TLL’s complaints in respect of the Signalling Principles. TLL argued that the Signally Principles Working Groups (“SPWG”) were the key
mechanism through which LUL sought to impose additional requirements on LUL. The Adjudicator, in rejecting this allegation considered that:

- in respect of LUL’s refusal to agree version 1 of the signalling principles, which TLL described as “exceptionally serious” breach by LUL: “If that is right, it appears not to have struck TLL in that way at the time” (paragraph 279);

- “Moreover, the evidence suggests, positively, that TLL did not consider LUL to be in breach” (paragraph 280);

- the SPWG was not, contrary to TLL’s contention, set up because there were deficiencies in LUL’s Category 1 Standards (paragraph 280) and that, properly understood, LUL attended the SPWG meetings to help TLL understand the signalling principles and how they applied in the context of the Jubilee Line and the Northern Line (paragraph 291);

- TLL made no contemporaneous complaint that LUL was misusing the SPWG to specify variations and “had TLL believed that LUL was making significant changes to its signalling principles outside the ambit of its existing Standards, it is inconceivable that TLL would not have taken advantage of the protection afforded by the Standards Code to claim additional costs. It did not do so” (paragraph 292);

- “TLL’s assertion that the complexity of the final 53 signalling principles is the best evidence of how LUL diverted the SPWG process from its original aim is a distortion of what occurred” (paragraph 293);

- “Not only is there no complaint about LUL’s conduct, there is a degree of commendation in relation to “good partnering”. The tone and content of the letter is a far cry from the tone and content of the submissions TLL now makes in relation to the same activities” (paragraph 296);

- Further, prior to February 2006, TLL made no valid complaint that the work of the SPWG had actually caused delay (paragraph 337). Further, the Adjudicator observed that “by adopting this process, TLL effectively removed the possibility of critical delay occurring. The Working Groups appear to have worked well”.

Route Secure is a key safety mechanism which has been deployed on the Underground Network for more than 20 years. The Adjudicator accepted that Route Secure was mandated by Category 1 Standards (paragraph 319). The Adjudicator further rejected TLL’s claim that these Standards were based on a fixed block system, and should have been changed. TLL did not use the Standards Code to make proposals for change or to claim additional costs (paragraph 319-323). The Adjudicator concluded:

- in relation to TLL’s case concerning alleged insistence by LUL on the Seltrac solution: “What it [i.e. TLL] now submits is markedly different from that which occurred contemporaneously” (paragraph 324);

- in relation to TLL’s case concerning the inherent functionality of Seltrac: “TLL’s case that it now advances is one that appears to have been fashioned with the benefit of hindsight” (paragraph 363).

Operational Concept and Requirements: The Adjudicator rejected TLL’s claims in respect of the Operational Concept and Requirements and determined that:

- the Operational Concept was not a requirements document (paragraph 575);
• TLL was responsible for producing the User and System Requirements Specifications (paragraph 561);

• LUL produced both an “as is” and a “future” Operational Concept as required by Standard E1035 (paragraph 566);

• the problems TLL experienced have not been caused by any failure of LUL’s to comply with Standard E1035 (paragraph 577).

**Assurance:** The Adjudicator rejected TLL’s claims in respect of Assurance, concluding that:

• by virtue of ROGS, LUL was entitled to receive assurance;

• in relation to TLL’s complaints regarding LUL’s conduct, “In the circumstances, there is an air of unreality about the complaints TLL now makes” (paragraph 469);

• the SRP was not formed to mitigate LUL’s failures (paragraph 464-465), further the SRP was chaired by an independent expert who would have constrained LUL if appropriate (paragraph 470);

• in relation to alleged interference: “Having read Appendix 6 to TLL’s June Submissions and the references recorded in Appendix 5 to TLL’s Reply Submissions (including the witness statements of [TLL]), I have no hesitation in rejecting the complaints” (paragraph 471);

• piecemeal assurance was a result of TLL’s and Thales’ shortcomings (paragraph 495).

Further, the Adjudicator was critical of TLL’s evidence is support of specific technical examples that were the subject of the operational requirements and required assurance. For example, in respect of TLL’s argument that LUL unreasonably required it to comply with a Standard that mandated SER Door Alarms, the adjudicator stated: “[TLL] say that although, the Standard required door alarms, the requirement was unnecessary because operational requirements were neither consistent nor clear! Given that the terms if the Standard required discussion and agreement on operational matters, [the] evidence is baffling” (paragraph 483).

The Adjudicator concluded that: “TLL appears to have struggled to perform its assurance obligations. There is no evidence of LUL being overbearing or meddlesome. Critically, nowhere is there any complaint by TLL that its difficulties have been caused by LUL delinquency or other default” (paragraph 495).

**Rolling Stock:** TLL’s claims in relation to Rolling Stock were based on LUL’s alleged unreasonable interference in the train modification process. The Adjudicator found that TLL’s claims failed on various grounds including:

• LUL had not acted unreasonably in respect of TLL’s particular complaints (for example paragraph 640, 644 and 650);

• no variation was sought at the time (paragraph 631);

• TLL had not given notice to LUL of any claim/no claim was made at the time for increased cost (paragraph 632).
Dear Chris

Draft directions on costs and related matters and initial thoughts on ISC setting and financing

This is to respond to your invitation to Transport for London (TfL) to make representations on the document you published on 17 December.

Firstly, it is worth reminding ourselves that the original purpose of the PPP was to secure private sector expertise to deliver improvements on time and on budget to overcome a perceived weakness in the public sector; and that a high return on equity to PPP shareholders was justified by the increased efficiencies that would supposedly arise from the private sector being in charge, by those who proposed this arrangement.

Instead, Tube Lines (TLL) is mired in problems with the Jubilee line Upgrade, likely to be up to a year late, which has been confirmed by the recent adjudication to be entirely the fault of TLL. These problems will now extend into the next review period, since work on the Northern line upgrade is only now starting and TLL intends to use the same method of implementing the new signalling on the Northern that was so heavily criticised in the recent adjudication.

Instead of greater efficiency, we have late delivery and unnecessarily disruptive working methods. It follows that the extraordinary fees extracted by the shareholders under their Secondment Agreement with TLL cannot be justified in the light of this poor performance. TfL argues strongly that they should be disqualified.

TfL is very concerned that you appear to have adopted the view that it is in your power to give instructions concerning the financing of the next review period that relieves TLL of any obligation to raise finance. TfL supports LU’s arguments that you do not have the power to do this (and we give further reasons for this below), but we also believe that, irrespective of strictly financial considerations, it is not in the public interest that the potential for the LUL Options should effectively be removed from the contract. TLL should prove itself in the financial markets, if further funding is needed, as the contract always envisaged.

TfL strongly rejects the suggestion that any further reduction in the scope of the PPP contract should be proposed. It would in any event be premature for scoping decisions to be taken before your costs direction is finalised and the funding gap is crystallized.
It is notable that the current affordability gap is very similar in size to the quantum of the unjustified and excessive Secondment fees. It would be a perverse outcome if some major aspect of the Tube renewal programme were to be cut simply in order that these massive fees could continue to be paid out.

Regarding the details of your draft findings, TfL welcomes and supports them in relation to the following:

- that the Restated Terms do not imply a material increase in risk;
- that the level of Minor Closures allocated by LU in Restated Terms would be sufficient for the Notional Infraco;
- that an alternative approach would have been adopted to delivery of the upgrades in the first review period by a Notional Infraco; and
- that LU has not behaved so as to inflate Infraco’s costs to any material extent.

On the last two matters, TfL invites you take into account the findings of the recent adjudication, described above, which found that none of the responsibility for the time and cost over-runs on the line upgrades is LU’s responsibility. Rather, LU was found to be a capable, disciplined and responsible commercial partner, whilst TLL was found to have managed key aspects of the upgrades poorly. Many of the arguments TLL has attempted to construct regarding the difficulty of working with LU now fall away.

TfL supports LU’s Representations in respect of matters not addressed in this letter.

You ask two specific questions, about affordability and financing for RP2.

**Affordability**

An analysis of the financing requirement was provided as part of LU’s Representations. TfL endorses that analysis, noting that LU’s Representations imply that the figures could reduce further in your final directions. However, it cannot be assumed that TfL would approve a budget at this level unless it had an appropriate degree of assurance as to the credibility of TLL’s plans for delivering its obligations within the Infrastructure Service Charge (ISC) that you direct. The willingness of lenders and equity to provide new finance would represent an important source of such assurance, as this would imply confidence on their part, following appropriate scrutiny of those plans.

**Funding for RP2**

As LU has argued, you have no power to set an ISC whose effect would be to impose a financing obligation on TfL. TfL is not subject to your jurisdiction. Even if you had such a power, it is no part of your function to ‘second guess’ what TfL would regard as value for money. TfL considers its financing on a portfolio basis, so as to secure - in the round - financing arrangements which represent good value in the light of TfL’s overall objectives.
It is not for you to override TfL’s judgement about how best to finance this aspect of its activities. Nor are you in any position to do so, since you have no knowledge of the facts and circumstances relevant to TfL’s decisions about the management of its financing portfolio. Any consideration of the relative costs of further funding needs to take into account all sources available to TfL, including reallocation of existing budgets or borrowing, increased revenues from fares or asset sales, additional grant funding from DfT (which TfL’s funding settlement allows for, although it could not be guaranteed) and additional borrowing, including possibly off balance sheet financing. You should therefore limit yourself to those decisions which are properly within your powers and remit, and leave to TfL those which are properly its to take. In any event, TfL supports the view expressed in LU’s Representations that it is premature to draw any conclusions on the issue of relative value for money prior to testing the market for finance raised by TLL.

Secondment Agreements

There is one further matter on which TfL considers your position to be untenable, that is the Secondment Agreements under which TLL’s shareholders earn very substantial fees.

You say at paragraph 6.32 of your draft Direction that you consider a Notional Infraco would keep the existing Secondment Agreements “provided payments under the agreement reflected [your] direction on Notional Infraco costs”. TfL understands that this is not currently the case, and that the Secondment Agreements in fact set cost targets which are greatly in excess of them, to the point where bonuses could be payable under them even where TLL was threatened with insolvency. Clearly, therefore, the incentives on the shareholders as seconding parties are not aligned with those of TLL, indicating that the Secondment Agreements are principally a vehicle for increasing returns to the shareholders.

TfL firmly believes that the excess payments to be made to the shareholders under the Secondment Agreements should be disqualified entirely, which is estimated would be a reduction of around £400m in the cost of RP2.

In summary, TfL’s position in response to your question is as follows:

1. No further de-scoping can be contemplated given all that is left is the major and critical line upgrades;

2. LU’s Restated Terms can be affordable within current TfL funding provided that:
   - the Arbiter accepts LU’s Representations and reduces his cost determination to £4.0bn or lower (including on the basis that the Secondment Fees paid out by TLL to its shareholders are unjustified and excessive); or,
   - the shareholders themselves admit that they are unjustified and terminate this element of their Secondment Agreements; or,
   - Government agrees to fund the difference, or permits additional public borrowing to do so; or,
   - TLL raises the additional finance as foreseen in the original PPP contract.

As suggested in your invitation, I am copying these representations to other stakeholders.
Yours sincerely,

cc
The Mayor – Boris Johnson
Secretary of State for Transport (copy to Bronwyn Hill)
Tube Lines’ shareholders: John Malarkey (Bechtel) and Chris Fenton (Amey)
Tube Lines’ lenders: EIB as Directing Creditor – Jaroslav Toth
APPENDIX 4 : DRAFT MAYORAL REPRESENTATION TO THE ARBITER

Chris Bolt CB
PPP Arbiter
One Kemble Street
London
WC2B 4AN

Dear Chris

Draft directions on costs and related matters and initial thoughts on ISC setting and financing

This is to respond to your invitation to make representations on the draft Directions document you published on 17 December.

I know that London Underground (LU) and, separately, Transport for London (TfL) have also made representations to you, which naturally I support.

While I will not repeat those detailed submissions here, I support their view that the work in the second period could have been delivered for £4.0bn or less by an efficient company.

However I strongly disagree with you on two key points, where you suggest that:

• you are not bound by LU’s Affordability Constraints;
• it will be for TfL rather than Tube Lines to raise any shortfall or, as an alternative, make further reductions in the scope of the work.

I firmly believe that each of these is out of line with the proposed intentions of the PPP. In particular, there can be no question of further reducing the scope of the improvements to be made to the Tube. London’s population continues to grow strongly and, alongside other investments in transport infrastructure, the Tube upgrades must be completed in full to ensure that London retains its place as the economic powerhouse of the UK and its transport system can accommodate and support London’s projected population and jobs growth. Failure to do so will simply repeat the mistakes of the past which led to a decaying and unreliable public transport system and a serious drag on London’s prosperity and status as a leading world city.

I therefore urge you strongly to reconsider your position on these issues in the light of the detailed representations from TfL and LU.

Furthermore, I find it extraordinary that Tube Lines’ shareholders, Ferrovial and Bechtel are permitted to benefit from so-called “Secondment Agreements” under the contract. In addition to a very substantial 26% return on their equity, I understand that these agreements allow the shareholders to receive very significant payments well above any direct cost of secondees that they bear. They are, in effect, an opaque way of providing quasi-equity returns to the shareholders from public funds in addition to their already generous return on equity that the contract provides for.
To my astonishment, I am told that over the full course of the first and second periods, payment under these agreements will total around £1.1bn, of which £800m can be regarded as profit once the market rate for the staff is deducted. Approximately £400m of this profit will be paid in the second period, a sum roughly equal to what is required to meet the likely shortfall in London Underground’s funding.

Londoners will want to know why they are being asked to de-scope the Tube upgrades so as to fund the payment of public money in this opaque and unjustified way to the benefit of shareholders, the same people who are nearly a year late delivering the Jubilee Line Upgrade, and who now threaten to impose further massive disruption on London with their approach to the Northern line upgrade. It is obvious that this money should be being invested in improving their Tube system, which is the stated objective of the PPP, not over-rewarding shareholders.

I urge you to disqualify any such payments to the Shareholders.

In short, there is no need to de-scope the contract, since the terms you suggest are affordable on a number of reasonable assumptions, one of them being that you put an end to the scandal of the fees extracted by the shareholders through the Secondment Agreement.

I look forward to your final determination and hope that we can begin to ensure that the taxpayer gets real value for money from the investment of public funds in London’s transport infrastructure.

Yours sincerely

cc
The Commissioner – Peter Hendy
Secretary of State for Transport (copy to Bronwyn Hill)
Tube Lines’ shareholders: John Malarkey (Bechtel) and Chris Fenton (Amey)
Tube Lines’ lenders: EIB as Directing Creditor – Jaroslav Toth